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People's Republic of China's Foreign Enterprises Income Tax Law and Regulations

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I. INTRODUCTION

As part of a continuing effort to strengthen and define its legal system and promote foreign investment, the People's Republic of China, during the Fourth Session of the Fifth National People's Congress on December 13, 1981, promulgated the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises¹ [hereinafter cited as Foreign Enterprises Tax Law or the Law]. Additional regulations for implementing the Foreign Enterprises Tax Law, the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises² [hereinafter cited as Foreign Enterprises Tax Regulations or the Regulations], were approved by the State Council on February 17, 1982, and promulgated by the Ministry of Finance on February 21, 1982. The speed with which China's Ministry of Finance issued the implementing regulations reflects the Chinese Government's recognition of the need for clear tax rules which will assist tax planning by foreign investors.

1. The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises [hereinafter cited as Foreign Enterprises Tax Law]. The English text of the Foreign Enterprises Tax Law may be found in O. NEE, F. CHU, & M. MOSER, *COMMERCIAL LAWS AND BUSINESS REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 1949-1983* §J7, at 41 (1982) [hereinafter cited as O. NEE]. The English text of most Chinese laws and regulations can also be found in *COMMERCIAL LAWS AND BUSINESS REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA 1949-1983* (V. Sit ed. 1983) [hereinafter cited as *COMMERCIAL LAWS*]. Both of these publications are available at the Center for Chinese Studies, University of California, Berkeley. The latter publication is available in both English and Chinese.

2. Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises [hereinafter cited as Foreign Enterprises Tax Regulations]. The English text of the Foreign Enterprises Tax Regulations may be found in O. NEE, *supra* note 1, §J7, at 49.

The newly promulgated Law and Regulations are designed to fill major gaps in China's taxation system by reaching previously ignored major sources of revenue. Previously enacted legislation established taxes on the income of foreign partners in equity joint ventures and on the income earned in China by foreign individuals.³ Currently, most foreign economic activities in China are in forms other than equity joint ventures; therefore, these laws reached only a minority of the foreign economic activities in China. More prevalent forms of trade and investment such as compensation trade, cooperative production, direct import, and export were not directly taxed.⁴

This Article provides a general introduction to the various provisions of the Foreign Enterprises Tax Law and Regulations, including the scope of the tax, applicable rates, special reductions in or exemptions from the tax, tax administration, and informal interpretations of the law by Chinese tax authorities that have become available. It does not discuss problems peculiar to specific industries, such as the petroleum industry, which have been the subject of specialized discussions.

This Article points out certain areas of the Foreign Enterprises Law and Regulations which remain unclear due to the newness of the Law and the lack of administrative history. It also analyzes the background of the Law and Regulations and offers some suggestions on how to avoid or possibly take advantage of the ambiguities which exist in the Law. The reader must bear in mind that the Chinese tax authorities' interpretations of the Law and Regulations included herein are informal and are not binding on the Chinese tax authorities.

II. DISCUSSION

A. The Taxpayers

The Foreign Enterprises Tax Law classifies taxpayers into two cat-

3. The Income Tax Law of the People's Republic of China concerning Joint Ventures Using Chinese and Foreign Investment [hereinafter cited as Joint Venture Tax Law], promulgated Sept. 10, 1980; The Individual Income Tax Law of the People's Republic of China [hereinafter cited as Individual Income Tax Law], promulgated Sept. 10, 1980 by the Third Session of The Fifth National People's Congress (the implementing regulations were promulgated on Dec. 13, 1980).

4. Some earlier indirect taxes do apply to the business activities of foreigners operating in China. These include the Consolidated Industrial and Commercial Tax Law; Real Estate Tax; Agriculture Tax; Vehicle Tax; Slaughter Tax; Salt Tax; Foreign Shipping Tax; Customs Duties; Livestock Trade Tax; and County Fair Tax. See Pomp & Surrey, *Taxation in the People's Republic of China*, in A NEW LOOK AT LEGAL ASPECTS OF DOING BUSINESS WITH CHINA 366-68 (H. Holtzmann & W. Surrey eds. 1979); Ho & Jack, *The Tax System of the People's Republic of China*, PRICE WATERHOUSE INT'L TAX NEWS 1, 65 (1981).

egories (1) taxpayers with "establishments," and (2) taxpayers without "establishments." Two different tax rates apply to these two categories of taxpayers.

1. Taxpayers With "Establishments"

Article 1 of the Law taxes "any foreign enterprise operating in the People's Republic of China," and defines "foreign enterprises" to include "companies, enterprises, and other economic organizations which have *establishments* in the People's Republic of China engaged in independent business operation or co-operative production or joint business operation with Chinese enterprises."⁵ The Foreign Enterprises Tax Regulations further define the term "establishments" as "organizations, places or business agents established by foreign enterprises in China engaged in production or business operations."⁶ The term "organization" includes "management organizations, branch organizations, representative organizations [and] factories."⁷ The term "places" includes "places where natural resources are being exploited and places where building, installation, assembling, exploration and other projects are being undertaken under contracts."⁸ Under this definition of "places," it is clear that cooperative oil exploration and development projects for offshore petroleum exploration are "establishments."

An "establishment" is subject to a progressive tax rate ranging from twenty percent to forty percent excluding local tax.

2. Taxpayers Without "Establishments"

If a foreign company does not have an "establishment" in China, it will be taxed at a fixed rate of twenty percent on China-source income such as interest, dividends, and royalty payments.⁹ The Regula-

5. Foreign Enterprises Tax Law, *supra* note 1, art. 1 (emphasis added).

6. Foreign Enterprises Tax Regulations, *supra* note 2, art. 2.

7. *Id.*

8. *Id.*

9. Foreign Enterprises Tax Law, *supra* note 1, art. 11. The Ministry of Finance issued two sets of provisional regulations granting tax reduction or exemption on income earned by foreign companies and enterprises from interest in China, and from fees for providing technical know-how. These provisional regulations were issued in Mar. 1983, effective as of Jan. 1, 1983. The English text of these regulations may be found in China Econ. News, Mar. 21, 1983. Article I of the Interim Provisions of the Ministry of Finance of the People's Republic of China Regarding the Reduction and Exemption of Income Tax on Interest Earned by Foreign Businesses from China [hereinafter cited as Provisional Regulations on Interest Earned] reduces the withholding tax rate for interest earned on contracts signed between 1983 and 1985 to 10%. The Provisional Regulations on Interest Earned also exempt interest from loans to China's state banks by foreign banks at the international interbank

tions provide that the Chinese paying unit must withhold tax on dividends, interest, rentals, and royalty payments.¹⁰ Apparently, the recipient can not reduce the amount required to be withheld by claiming deductions attributable to the generation of such payments. For example, research and development fees against royalties paid by Chinese technology licensees to foreign licensors will not reduce the sum withheld. Interpretation and tax planning considerations arising from differences between the application of different rates to these two types of income are examined below.¹¹

3. Problems of Interpretation

Foreign taxpayers must determine whether they fall under the definition of "establishment." The definition, however, does not fully express the nature of the activities taxable under the Foreign Enterprises Tax Law and Regulations, so it is unclear exactly what types of foreign

loan rates and interest income from loans to China National Offshore Oil Corporation at a rate no higher than the interbank loan rates and interest earned on deferred payments received by sellers of technology, equipment, and commodities to Chinese companies at an interest rate no higher than that charged to the Chinese. Interest on deposit in China's state banks where the deposit by either a foreign bank or individuals earns an interest at a rate lower than that available on deposits in the country of the depositing bank or depositor and interest earned by the provider of technology in a compensation trade arrangement are also exempt, pursuant to Article II(5) of the Provisional Regulations. Under Article III, income on leasing fees are now taxed during the period of 1983 to 1985 at a reduced rate of 10%.

Article I(1) of the Interim Provisions of the Ministry of Finance of the People's Republic of China Regarding the Reduction and Exemption of Income Tax on Fees for the Use of Proprietary Technology [hereinafter cited as Provisional Regulations on Proprietary Technology] reduces the 20% withholding tax to 10% for technology fees earned from proprietary technology and exempts technology which is advanced and provided to the Chinese with preferential terms. Fees received for technology used in the development of agriculture, forestry, fishery, and animal husbandry production, etc.; fees received for technology used in conducting scientific research; fees received for technology used for development of energy; fees received for communication and transport; fees received for technology used in areas of energy conservation and environmental protection; and fees for technology used in production of advanced electronic equipment, nuclear technology, large scale integrated circuits, optical integration, microwave semiconductors, microwave integrated circuits, microwave electron tubes, ultra high speed computers, microprocessing machines, fibre optics communication, long distance super high pressure direct current electricity transmission, and liquification, gasification, or multiple use of coal are now taxed at a 10% rate for contracts signed between 1983 and 1985. Under Article IV, fees received for services in connection with improving, reforming and assisting operation management, training, construction and presentation of technical knowledge; as well as assistance in achieving technical targets stipulated in contracts, design, technical instructions, civil engineering construction design, and technological process design and quality inspection in data analysis for the transfer of the technology are exempt from taxation.

10. Foreign Enterprises Tax Regulations, *supra* note 2, art. 28.

11. See *infra* text accompanying notes 27-30.

presence might be included. Article 2 of the Foreign Enterprises Tax Regulations includes examples¹² but does not appear to provide an exhaustive list. The following discussion illustrates some of the problems which have already arisen.

a. *Agents*

Foreigners have expressed the concern that an agent's activities may cause the Chinese to treat the principal as having an "establishment" in China. The most troublesome questions created in this connection by the Law and the Regulations arise from the failure of either set of rules to define the "business operations" other than "production" which qualify as activities creating an "establishment." Neither the Law nor the Regulations clearly define the level of an agent's activities in China which would classify the foreign principal as having an "establishment." Although no official interpretation has been issued in writing, Chinese tax authorities¹³ suggest that a determinative criterion for tax liability may be the agent's possession of authority to conclude a contract in China. If the agent possesses such authority, the foreign principal will be deemed to have an "establishment" in China. If the agent merely engages in promotional and "liaison" work and has no authority to conclude contracts, the agent's activity would not subject the taxpayer to the progressive tax rate.¹⁴

The situation becomes more complex if an agent represents several principals and has different degrees of authority from each of the principals. Whether, and under what circumstances, the Chinese would tax *each* principal as an establishment is unclear. At least one Chinese tax official has indicated that an agent who worked for more than one principal would be considered an "independent" agent and that the activities of such an "independent" agent would not create an "establishment" for each principal.¹⁵ This statement, however, must be read in context with the developing importance of the distinctions be-

12. Foreign Enterprises Tax Regulations, *supra* note 2, art. 2.

13. In tax seminars sponsored by Price Waterhouse International on June 24, 1982, in Hong Kong, New York, and Houston, Mr. Liu Zhicheng, Head of the General Tax Department of the Ministry of Finance, and Madame Zhang Yiming, Director of the Foreign Tax Division of the General Tax Department, both stated that the authority of the agent to conclude contracts would be an important criterion in determining whether the principal had an "establishment" in China [hereinafter cited as Price Waterhouse Seminars].

14. Depending upon length of stay in China, the agent, however, would be subject to the Individual Income Tax Law, *supra* note 3, and the principal itself would be considered to have an "establishment."

15. Price Waterhouse Seminars, *supra* note 13.

tween the different types of authority exercised by the agent. The independent agent would be considered an "establishment" and would be liable for taxes under the law.

b. *Representative Offices*

Many foreign investors have registered "representative offices" in China under the Provisional Regulations Concerning the Control of Resident Representative Offices of Foreign Enterprises in China.¹⁶

Some of the offices, although registered to engage in "business activities," merely disseminate information or promote a foreign company's products. So long as these particular representative offices are not "conducting business" in China, it is uncertain how they will be treated under the Law. The Chinese term used in the Law for "representative office" is identical to that used in the Regulations Governing Representative Offices.¹⁷ Neither the Law nor the Regulations Governing Representative Offices indicate whether the drafters intended to cover identical activities. The Beijing Tax Bureau has stated that if the local representative possesses and habitually exercises the authority to conclude contracts, the foreign enterprise will be considered to have an "establishment."¹⁸

As in the case of an agent, however, if a foreign company authorizes its representative office to solicit bids for desired products but the principal signs the actual purchase contract outside China, it is unclear whether the representative's presence in China may cause the principal to be identified as an "establishment." Most contracts are signed in China. Nevertheless, a provision stating that a contract so signed will not take effect unless approved by the home office outside of China may exempt the contract proceeds from taxation. Use of so simplistic a criterion as the place where the contract is signed may seem mechanical, but it comports with a frequently espoused Chinese preference for "simple" solutions.

c. *Sales from Abroad*

As noted above, some Chinese tax authorities have suggested that contracts for the sale of equipment and services from abroad, which

16. Provisional Regulations of the State Council of the People's Republic of China Concerning the Control of Resident Representative Offices of Foreign Enterprises, Oct. 30, 1980 [hereinafter cited as Regulations Governing Representative Offices].

17. *Id.*

18. Nee, *Regulations to the Foreign Enterprise Income Tax Law Issued*, EAST ASIAN EXECUTIVE REPORTS, Apr. 1982, at 5, 6.

were not signed in China by a resident agent or resident representative who habitually exercises the power to negotiate and sign contracts on behalf of the principal or home office, will not be regarded as China-source income. Foreign companies which sell to China should plan transactions carefully to take advantage of this mechanistic approach. Structuring transactions so that foreign representatives who are not normally residing in China can engage in negotiations may be important. Signing contracts abroad will obviously also be useful, although it may not prove to be determinative.

d. *Performance of Services Within China*

Similar problems will arise when services are performed in China. Recurring definitional gaps in the Law and Regulations make it unclear how much time spent in China by employees of a foreign company installing equipment, completing construction, or engaging in other work will create an "establishment" for that company.

From the foreign party's viewpoint, tax considerations might make it desirable to segregate clearly taxable China-source income, such as payments for services performed in China, from possibly nontaxable sources of income arising under the same contract, such as payments for services performed abroad. In this regard, however, it should be noted that Chinese trade corporations have in the past frequently lumped together services performed inside as well as outside China.

In certain transactions, it may be advantageous to establish separate enterprises to perform services, thereby reducing the taxable income of each enterprise and the effective tax rate on their combined income.

e. *Compensation Trade, "Cooperative Production," and Processing Contracts*

In compensation trade, a foreign company supplies equipment and, sometimes, technology and training and is repaid with products manufactured in China using the equipment supplied. Neither the Law nor the Regulations mention compensation trade. The Ministry of Finance has stated that "in principle" such transactions will not be taxable, although such transactions will be subjected to case-by-case examination.¹⁹ Since compensation trade is the payment for goods or technology with another product, the exclusion seems natural. By contrast, "joint business operations" in which both the foreigner and the

19. *Id.* at 8.

Chinese contribute in the production are specifically included within the coverage of the Law.²⁰

B. Taxable Income

Article 2 of the Law imposes the tax on a foreign enterprise's "net income."²¹ Article 4 of the Regulations further provides that taxable income includes income derived from production and business operations, dividends, interest income, income from the lease or sale of property, technology, trademark rights, copyrights, and "other non-operating earnings."²² No distinction is made between income from capital investments and ordinary business income. The following discussion focuses on some problems that have arisen with regard to the definition of taxable income.

1. Source of Income

Since Article 1 of the Law states that only income derived from China will be taxed under the Law,²³ the list of types of taxable income in the Regulations is presumably intended to describe only China-source income, although it does not specifically so state.²⁴ Even under this assumption, it is unclear how the Chinese will interpret various source-tracing rules. It would be possible, for example, as noted above in discussing entities subject to tax, for a foreign company to structure a transaction so that the sale of goods occurs outside China, thereby circumventing the definition of "sources within China." The Chinese authorities may, however, eventually develop source-tracing rules which will ignore the form of such transactions and impute the income as China-sourced income.

A particular problem may arise with respect to commissions paid by foreign principals to foreign agents when the commissions arise out of transactions involving China even if the payments are made completely outside China (as they usually are). Representatives of both the Ministry of Finance and the Beijing tax authorities have stated that they are "studying" the feasibility of taxing such commissions. The primary obstacle to taxing these commissions is enforcement. The Chinese authorities are unlikely to know about these payments.

Another set of problems may arise out of transactions in which a

20. Foreign Enterprises Tax Regulations, *supra* note 2, art. 3.

21. Foreign Enterprises Tax Law, *supra* note 1, art. 2.

22. *Id.* art. 4.

23. *Id.* art. 1.

24. *Id.*

foreign company provides technology and equipment and performs services such as installation, engineering, and construction. The structuring of this type of transaction was previously discussed above in connection with the concept of "establishment."²⁵ It is highly likely that at least part of the income from such projects, such as fees for installation services performed in China, will be taxed on a net basis. Again, foreign investors may wish to consider establishing separate entities to provide such services to lower the applicable tax rate.

Other fees such as license fees will be subject to the twenty percent withholding rate.²⁶ With respect to such transactions, tax planning and prior discussion with Chinese tax authorities is advisable, subject, of course, to the uncertainties that will inhere in the system as long as interpretations remain informal. If transactions are structured using several contracts in order to take advantage of the different types of taxable income, careful documentation of each contract must be maintained.

2. Taxability of Different Types of Income

The Law and the Regulations have made no provisions for tax treatment of different types of income earned by the same taxpayer. For instance, when the activities of a taxpayer with an "establishment" otherwise generate China-source income in the form of operating profits, royalties, interest, or profits on sales in discreet transactions not involving that "establishment," will such different types of income be taxed separately or lumped together? One author has stated that: "in both FEITL [Foreign Enterprises Income Tax Law] and the regulations, the Chinese appear to have adopted the "force of attraction" principle whereby *all* China-source income of a foreign company with an establishment in China automatically is attributed to the establishment and taxed accordingly."²⁷ The Foreign Tax Bureau of the Ministry of Finance, however, has stated exactly the opposite in informal conversations, in other words, that different types of income would be taxed separately.²⁸

25. See *supra* text accompanying notes 3-9.

26. For contracts signed between 1983 and 1985 the withholding rates can be reduced to 10%. Provisional Regulations on Proprietary Technology, *supra* note 9, arts. 1, 2. Such contracts may even be exempt from the withholding tax if the fees are received for a transfer of technology which is used in an industry listed in the Provisional Regulations on Proprietary Technology. *Id.* art. 1(1).

27. Beukema & Gelatt, *China's Income Tax Laws for Foreign Enterprises*, Asian Wall St. J., Mar. 8, 1982, at 6.

28. Interview by T. Chiang, of the National Council for U.S.-China, with Li Shizi, head

Chinese authorities have indicated informally that they will probably resolve problems of this type by focusing on the identity of the paying unit and the recipient.²⁹ Passive income paid directly to the foreign enterprise's home office will most likely be subject to the withholding tax, whereas payments of such income made to the foreign enterprise "establishment" in China will be taxed at the progressive tax rate. The Chinese authorities will also consider the "relation" of the two types of income. If the passive income relates directly to the activities of an establishment, then the two types of income may be aggregated and taxed at the progressive rate.³⁰

3. Net Income: In General

Article 9 of the Regulations includes detailed formulas for computation of taxable income, which are generally similar to those in the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment [hereinafter cited as the Joint Venture Tax Regulations].³¹

It should be emphasized that in some instances the Chinese tax authorities will apply a "notional or deemed profit concept" when "evidence of accurate costs and expenses" can not be provided.³² For example, the income of subcontractors in oil exploration projects will be deemed to be ten percent of the contract price,³³ while the profit on freight and carriage contracts will be deemed to be five percent.³⁴ The Chinese tax authorities may eventually consider taxing the subcontractors on their actual realized net income if sufficient evidence of costs and expenses can be demonstrated by the subcontractors and the creditability of the deemed tax is in question.³⁵

The Regulations also provide for deduction of major expenses in-

of Foreign Tax Office, Beijing Municipal Tax Bureau, in Beijing [hereinafter cited as Li Interview].

29. Price Waterhouse Seminars, *supra* note 13.

30. *Id.*

31. Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment [hereinafter cited as Joint Venture Tax Regulations], art. 8. This may be located in COMMERCIAL LAWS, *supra* note 1.

32. Foreign Enterprises Tax Regulations, *supra* note 2, art. 24.

33. Nee, *supra* note 18, at 81.

34. Foreign Enterprises Tax Regulations, *supra* note 2, art. 24.

35. See *Letter Ruling Says Oil Firms Can Credit New Chinese Taxes*, TAX NOTES, July 12, 1982, at 151. This ruling does not include the deemed tax as a creditable income tax.

curred in producing income and list the following non-deductible expenses:

1. Expenditure for the purchase or construction of machinery, equipment, buildings, facilities and other fixed assets;
2. Expenditure for the purchase of intangible assets;
3. Interest on capital;
4. Income tax payments and local surtax payments;
5. Penalties for illegal operations and losses in the form of confiscated property;
6. Overdue tax payments and tax penalties;
7. Losses from windstorms, floods, and fire risks covered by insurance indemnity;
8. Donations and contributions other than those for public welfare and relief purposes in China;
9. Royalties paid to head offices;
10. Other expenses that are not relevant to production and operation.³⁶

4. Net Income and Deductions

During the promulgation of the Foreign Enterprises Tax Law, consideration was given to providing rules on debt/equity ratios. The Law as promulgated, however, did not include a debt/equity ratio.

In order to properly administer the Law and Regulations by the Ministry of Finance and allow the taxpayers to properly calculate their tax liabilities, the following issues merit particular attention.

The Law and Regulations provide that certain deductions are not permitted. Among them are interest on capital, interest on loans, entertainment expenses, local tax payments, royalty payments to head offices, administrative expenses, and administrative expenses which are unreasonable.³⁷

a. *Deductions Limited or Not Permitted*

1) Interest

i) Non-deductibility of "Interest on Capital"³⁸

This item, specified as such in the list of nondeductible expenses,

36. Foreign Enterprises Tax Regulations, *supra* note 2, art. 10.

37. *Id.*

38. *Id.* art. 10(3).

was puzzling. The Ministry of Finance has clarified the meaning of this provision, interpreting it as "interest on *equity* capital."

ii) Deductibility of "Interest on Loans"³⁹

The Regulations do not indicate the criteria for deciding what is "interest on loans." The tax authorities will probably attempt to evaluate the need for the loan "objective" with an eye for justification, such as business expansion or other reasonable business purposes, and will pay particular attention to intracompany loans.

2) Entertainment Expenses

One provision limits deduction of entertainment expenses.⁴⁰ The deductions for entertainment expenses is limited to 0.3% of annual net sales up to fifteen million *Renminbi* and 0.1% of net sales over fifteen million *Renminbi*.⁴¹ Entertainment expenses for foreign enterprises with annual business income below five million *Renminbi* is limited to one percent of gross business income. For enterprises with annual gross income exceeding five million *Renminbi*, the entertainment expense deduction is limited to one percent of the first five million *Renminbi* and three percent of gross income in excess of five million *Renminbi*.⁴² This provision is intended to deter larger and more profitable foreign enterprises from spending great amounts for entertainment purposes at the government's expense. A foreign establishment may, however, be able to blunt the impact of these restrictions by allocating some entertainment expenses to its head office, for example, to a United States company which can deduct certain expenditures under United States tax laws.⁴³

3) Local Tax Payments

All income tax and local income tax payments to provincial and local authorities in China are also nondeductible. No reference is made to income taxes paid to a foreign country. In marked contrast, the Joint Venture Tax Law allows income tax payments to other countries as a deduction against tax liabilities to the Chinese government.⁴⁴

39. *Id.* art. 12.

40. *Id.* art. 13.

41. One U.S. dollar equals approximately \$2.00 *Renminbi*. See Asian Wall St. J., Foreign Exchange section, for daily quotations of conversion note.

42. Foreign Enterprises Tax Regulations, *supra* note 2, art. 13.

43. See I.R.C. § 274(a) (West 1983).

44. Joint Venture Tax Law, *supra* note 3, art. 16.

The Law is also unclear on whether a foreign company operating in China in different forms, both as an "establishment" and as a joint venture, and thereby paying tax under the two separate laws applicable to the two types of activities, will be able to deduct from payments under one law any or all of its income tax payments to the Chinese authorities under the other.

4) Royalty Payments

Other nondeductible items which may cause some concern are royalty payments to a "head office."⁴⁵ The Law and Regulations are unclear as to the definition of a "head office," whether royalties paid to affiliated companies are also nondeductible, and what percentage of control will cause a parent or affiliated royalty recipient to be classified as a "head office." Although the nondeductibility of these items might have adversely affected the creditability of taxes paid to the Chinese in satisfaction of United States tax liabilities,⁴⁶ a recent Internal Revenue Service private letter ruling stating that the tax is creditable seems to have resolved this matter.⁴⁷

5) Administrative Expenses

Article 11 of the Foreign Enterprises Tax Regulations allows the deduction of "reasonable administrative expenses paid by a Foreign Enterprise to its Head Office . . ." and requires that such expenses be properly documented by receipts and vouchers.⁴⁸ This Article also provides that if a contract signed by a foreign enterprise with a Chinese enterprise in a cooperative production or joint business operation includes an agreement allocating specific administrative expenses, then the parties may deduct the listed administrative expenses according to the allocation specified in the contract.⁴⁹

Foreign enterprises engaging in such business relationships should

45. Foreign Enterprises Tax Regulations, *supra* note 2, art. 10(9).

46. If these nondeductible items were considered "significant," their disallowance would distort the "net income" of the enterprise. See Proposed Treasury Regulations 4.901-2(c)(4)(i) T.D. 7739, 1981-1 C.B. 396, 400 (1981). See also *Inland Steel v. United States*, 47 A.F.T.R.2d (P-H) 81-349. (Canadian charge not creditable for failure to allow for deductions of certain capital costs, e.g., deduction on interest, dividend, royalty payments, depletion, and pre-production expenses.)

47. See *Letter Ruling Says Oil Firms Can Credit New Chinese Taxes*, *supra* note 35; Nordberg & Price, *People's Republic of China: New Income Tax on Foreign Enterprises*, TAX MGMT. INT'L J., July 1982, at 8.

48. Foreign Enterprises Tax Regulations, *supra* note 2, art. 11.

49. *Id.*

carefully detail in their contracts methods of allocation that shift costs to the offices operating in China in order to take advantage of the deduction. Tax authorities in Beijing have indicated that under these provisions, other payments for direct services from affiliated companies will also be deductible. It should be noted that Article 11 of the Regulations requires examination and approval of the contract provisions by the local tax office.⁵⁰ The taxpayer should itemize in detail the intracompany payments which the taxpayer intends to deduct. In this regard, Article 24 of the Regulations provides that if a foreign enterprise is unable to compute its costs and its taxable income in China, local tax authorities have the power to estimate taxable income based upon the net volume of sales or gross income of a similar enterprise.⁵¹

The Regulations state that vouchers and receipts are required to be in Chinese or in both Chinese and the taxpayer's foreign language.⁵² Vouchers used must be approved and accounting entries must be made based upon approved vouchers.⁵³ Any change in a form of receipt approved by the local tax authority presumably must be reported to the tax authorities for further approval. All receipts, vouchers, and financial reports are to be prepared by a "chartered public accountant" registered in China.⁵⁴ Neither the Law nor the Regulations state whether a foreign accountant operating in China may qualify. The audited "head office" accounts must also be submitted. Moreover, the accounting firm which audits the *head office* accounts, even if it conducts no activities in China and does not wish to, must be "recognized" by tax authorities in China. Such an accounting firm must approach the authorities either by letter or in person (in China) to obtain some form of recognition, such as a letter from the Chinese taxing authorities.

b. *Other Issues: Dividends*

One commentary has noted that dividends from an "establishment" in China may be treated as dividends from "an enterprise in China," taxable at the twenty percent rate.⁵⁵ In certain instances, companies may be subjected to a high tax burden which would not be entirely deductible against United States taxes. For example, if a foreign

50. *Id.*

51. *Id.* art. 24.

52. *Id.* art. 39.

53. *Id.* art. 40.

54. *Id.* art. 36.

55. Beukema & Gelatt, *supra* note 27.

subsidiary responsible for business activities in China paid a dividend to its parent from income remaining after payment of the Chinese progressive tax on establishments, then an additional twenty percent withholding tax would be imposed on the after-tax dollars paid as that dividend.

C. Tax Rate

The Foreign Enterprises Tax Law begins taxation of an establishment's annual income at a twenty percent rate, which progressively increases to a maximum rate of forty percent on annual income over one million *Renminbi*.⁵⁶

1. Local Tax

The Foreign Enterprises Tax Law also imposes an additional ten percent local tax assessed on taxable income, making the effective rate range from thirty percent to fifty percent.⁵⁷ The local tax is payable at the same time that national taxes become due.⁵⁸ The Foreign Enterprises Tax Law also allows local authorities to waive the local tax for enterprises engaging in "small scale production" or having "low profits,"⁵⁹ posing the possibility of internal competition as local authorities seek foreign investments by waiver or reduction of the local tax. The ten percent tax imposed by the local authorities under the Foreign Enterprises Tax Law differs considerably from the ten percent local tax under the Joint Venture Tax Law. The ten percent local tax assessed under the Foreign Enterprises Tax Law is on the annual *taxable income* of the foreign taxpayer,⁶⁰ whereas the ten percent tax paid under the Joint Venture Tax Law is a surtax on the amount of tax *paid*.⁶¹

2. Actual Rate

A calculation of the actual tax rate is provided for in the chart on the following page.

56. Foreign Enterprises Tax Law, *supra* note 1, art. 3.

57. *Id.* art. 4.

58. *Id.*

59. *Id.*

60. *Id.*

61. Joint Venture Tax Regulations, *supra* note 31, art. 3.

62. Cheung, *The Long Awaited New Tax Law*, ECON. REP., Jan. 1982, at 7.

Annual income of foreign enterprise	NATIONAL TAX			LOCAL SURTAX			TOTAL TAX	
	Tax Rate %	Amount (yuan)	Accumulated Amount (yuan)	Real Tax Rate (%)	Tax Rate %	Amount (yuan)	Amount (yuan)	Real Tax Rate %
(Unit: Renminbi: yuan)								
up to 250,000	20	50,000	50,000	20	10	25,000	75,000	30
250,001 to 500,000	25	62,500	112,500	22.5	10	50,000	162,000	32.5
500,001 to 750,000	30	75,000	187,500	25	10	75,000	262,500	35
750,001 to 1 million	35	87,500	275,000	27.5	10	100,000	375,000	37.5

For those foreign enterprises with annual income more than renminbi 1 million yuan,

$$\text{National tax: } T(X) = 275,000 + 0.4 (X - 1,000,000)$$

Where X is the annual income of the enterprise and 275,000 is the national tax on the first million yuan of the annual income. 0.4 or 40% is the tax rate levied on the national income of more than 1 million yuan.⁶²

Source: Economic Reporter, English Monthly, January 1982.

Article 5 of the Regulations also provides that the taxable income should be calculated according to the same formulas provided in Article 9 of the Regulations.⁶³ This provision indicates that only the central tax authorities will be able to determine what is taxable income, thus clarifying some speculation after the initial announcement of the tax law that local authorities may be allowed to make independent tax calculations.⁶⁴

3. Taxation as an "Establishment" Versus Taxation at the Withholding Rate: The Possibility of Choice

A foreign company with a representative office but without active China-source income may find it desirable to be treated as an "establishment" in order to take advantage of deductions permissible under the Law and the Regulations available only to an "establishment." This status could be achieved by expanding the contract signing authority of the representative resident in China having payments for services paid directly to the representative office, and having all necessary services rendered from the representative office. After deductions, the effective tax rate for an "establishment" could be lower than the twenty percent withholding tax on the same gross income. Along with the loss carry over provisions, in certain situations an "establishment" can significantly reduce taxable income in China.

D. Tax Reductions and Exemptions

As in the Joint Venture Tax Law, the Foreign Enterprises Tax Law and Regulations provide for certain incentives for companies engaging in "low-profit" operations.⁶⁵ The Regulations define low-profit enterprises as enterprises with annual incomes of less than one million *yuan*.⁶⁶ Any enterprise with annual income over one million *yuan*, regardless of the nature of its operation, would seem to be disqualified for any waiver of the local tax.⁶⁷ The Regulations also specifically include deep mining operations for coal as a type of enterprise with low-

63. Foreign Enterprises Tax Regulations, *supra* note 2, art. 5. Some translations of the Regulations mistakenly refer to article 8 as embodying the formulas.

64. See Gelatt & Pomp, *Foreign Enterprises Income Tax Law Adopted*, E. ASIAN EXECUTIVE REP., Jan. 1982, at 3, 6.

65. Foreign Enterprises Tax Law, *supra* note 1, art. 4.

66. Foreign Enterprises Tax Regulations, *supra* note 2, art. 6. The term *Renminbi* or *RMB* literally translated is "People's currency." *Yuan* is used as a denomination of the *Renminbi*. The two terms are interchangeable when used to refer to denominations of the Chinese currency.

67. *Id.* art. 4.

profit rates.⁶⁸ These tax incentives reflect the Chinese government's efforts to encourage investments in certain sectors of the economy, and to encourage long-term investments in China by foreign companies.⁶⁹

Enterprises which are scheduled to engage for a period of ten years or more in farming, forestry, animal husbandry, and other low profit activities may be allowed an exemption from income tax for their first profit-making year. In the second and third profit-making years, these enterprises *may* be allowed a fifty percent tax reduction at the discretion of the tax authorities.⁷⁰ The exemption and reduction requires the approval of the Ministry of Finance. The Law further provides that the Ministry of Finance may also allow a subsequent fifteen percent to thirty percent reduction of the income tax payable for the following period of ten years for these enterprises.⁷¹

E. Tax Avoidance By Contract

Shifting the tax burden to Chinese organizations by contract is likely to become increasingly difficult. Prior to enactment of the Law, Chinese contract clauses customarily provided that all Chinese taxes would be paid by the Chinese party to the contract. Chinese trade corporations, however, have recently insisted upon clauses specifically requiring the foreign party to pay their share of taxes under the Law. The Ministry of Finance has publicly indicated that clauses which circumvent payment of taxes by contractual provisions are no longer permissible.⁷² Such contractual clauses approved prior to the enactment of the Law will be binding upon the parties. These clauses, however, will not be valid during any extension of the approved contracts. As a matter of principle, the Ministry of Finance seems equally opposed to clauses under which the foreign company pays the tax but is *reimbursed* by the Chinese party. Companies are advised to obtain clarification from the Ministry of Finance on the validity of reimbursement clauses before their inclusion in any contract.

68. *Id.* art. 7.

69. The Provisional Regulations on Proprietary Technology, *supra* note 9, also provide for tax reduction for technology fees received relating to, *inter alia*, the development of agriculture, forestry, fishery, and animal husbandry. This further reflects the Chinese government's effort to encourage certain sectors of the economy.

70. Foreign Enterprises Tax Law, *supra* note 1, art. 5.

71. *Id.*

72. Price Waterhouse Seminars, *supra* note 13.

F. Accounting Principles

The Foreign Enterprises Tax Regulations also prescribe depreciation and amortization schedules for tangible and intangible assets, respectively.⁷³ The depreciable basis of tangible assets is the excess of original cost over salvage value. All assets must be depreciated under the straight line method. A minimum useful life is provided for certain assets: (1) houses and buildings—twenty years; (2) trains, ships, machines, equipment, and other facilities for the purpose of production—ten years; (3) electronic equipment, means of transport, trains, ships, and appliances, apparatus, and furniture relevant to production and operation—five years.⁷⁴

Accelerated depreciation is allowed if approval from the Ministry of Finance is obtained. The Law and the Regulations, however, did not provide any limits or tests for determining when approval will be allowed.⁷⁵ Improvements or technical innovations which prolong the life of a fixed asset must be treated as adjustments to basis, and depreciation deductions must be taken over the extended remaining useful life.⁷⁶

Since depreciation is based upon cost, it should be possible to structure transactions so as to purchase depreciable equipment and assets from a related party outside China at the highest possible price. The enterprise may wish to lease nondepreciable equipment and take advantage of expense deductions. The maximum tax rate on rental income under Article 11 of the Law is twenty percent. A high bracket taxpayer leasing from a related party could deduct up to forty percent of the lease payments, while the related party would pay only the twenty percent withholding tax.⁷⁷ If purchase of equipment is necessary, the purchase could be structured as a package with the primary cost allocated to the assets with the shorter useful life, thereby effectively accelerating the combined depreciations.

The Regulations also provide for the amortization of pre-incorporation expenses.⁷⁸ It is unclear, however, whether such pre-incorporation expenses could include pre-contract expenses.

Like the Joint Venture Tax Law, the Foreign Enterprises Tax Reg-

73. Foreign Enterprises Tax Regulations, *supra* note 2, arts. 17, 18, and 21.

74. *Id.* art. 18.

75. *Id.*

76. *Id.* art. 19.

77. A reduction may also be available for tax on the leasing fees received in accordance with article 3 of the Provisional Regulations on Interest Earned, *supra* note 9.

78. Foreign Enterprises Tax Regulations, *supra* note 2, art. 22.

ulations also require accounting on an accrual basis.⁷⁹ It should be noted, however, that passive income is deemed earned when paid.⁸⁰ If a taxpayer has both types of income, proper timing of the payment of passive income may result in tax benefits.

Like the Joint Venture Tax Law, the Foreign Enterprises Tax Regulations also provide fairly detailed accounting rules on such matters as cost accounting of inventory sold, record-keeping procedures, audit procedures, and provisions for penalties in case of violation of tax laws.⁸¹

G. Special Problems: Treatment of Banks

In order to encourage foreign investors to make deposits in Chinese banks, interest on funds deposited in China's state banks is exempt from taxation if the foreign enterprise's home country also exempts interest on deposits by China's state banks from taxation.⁸²

China will not tax interest income on a foreign bank loan to a Chinese state bank⁸³ if the loan is given at a "preferential interest rate."⁸⁴ "Preferential rate" is defined in the Regulations as a "rate which is at least ten percent less than the general interest rate in the international monetary market."⁸⁵ This provision, although designed to attract foreign loans to China, may not achieve the intended result. If it requires a *flat* ten percent point reduction in the interest rate for a foreign bank to obtain this particular exemption, the loan must be almost unbelievably lower than the market rate, e.g., at six percent if the prime rate is sixteen percent. Only international finance organizations such as the World Bank would be likely to make loans at these rates. Most commercial banks would unlikely be tempted by this provision, given such a substantial differential in interest rate. This provision,

79. Compare Joint Venture Tax Regulations, *supra* note 31 art. 23 with Foreign Enterprises Tax Regulation, *supra* note 2, art. 38.

80. Joint Venture Tax Regulations, *supra* note 31, art. 32; Foreign Enterprises Tax Law, *supra* note 1, art. 11.

81. Foreign Enterprises Tax Regulations, *supra* note 2, arts. 23, 24, 38, 39, 43-46; Joint Venture Tax Law, *supra* note 3, arts. 13, 14.

82. Foreign Enterprises Tax Law, *supra* note 1, art. 11.

83. Article 30 of the Foreign Enterprises Tax Regulations lists the state banks—The People's Bank of China, the Bank of China, the People's Construction Bank of China, the Agricultural Bank of China, the Investment Bank of China, and the International Trust and Investment Corporation—which have been authorized by the State Council to engage in deposits, loan, and credit business operations externally. Foreign Enterprises Tax Regulations, *supra* note 2, art. 30.

84. Foreign Enterprises Tax Law, *supra* note 1, art. 11.

85. Foreign Enterprises Tax Regulations, *supra* note 2, art. 29.

however, may also be interpreted as requiring only a ten percent *discount* from the prevailing rate. For example, if the prevailing world interest rate were sixteen percent, a loan to a Chinese bank at fourteen percent would qualify for the exemption. Under this interpretation, the provision would create a realistic incentive for foreign banks to lend to China. Considering the twenty percent withholding tax, however, banks have been reluctant to make loans to China or have been making loans by passing on the costs of the withholding tax to the Chinese borrowing enterprises.

At least for the period between 1983 and 1985, lending to a Chinese state bank at the inter-bank loan rate would qualify as a "preferential rate."⁸⁶ As such, the foreign banks should have an incentive to make loans to Chinese state banks.

As previously suggested, a foreign company whose income is subject to the twenty percent withholding rate might prefer to create an "establishment" in order to offset income with deductions. Banks may benefit from a similar arrangement. Originally, foreign banks with representative offices in China were prohibited from engaging in profit-making activities in China; thus, they were not likely to be considered by the Ministry of Finance to have "establishments" in China and would not be able to utilize any deductions. A recent article, however, indicates that the term "establishments" does include representative offices of foreign banks.⁸⁷ In such an event, the bank would do well to expand their activities and be classified as an "establishment." Instead of the twenty percent (or ten percent for the period between 1983 and 1985)⁸⁸ withholding tax on the amount of the loan, a bank having an "establishment" would only pay a progressive tax on the net income from the loan. This latter sum could be substantially lower.

H. Administrative Procedure

The Foreign Enterprises Tax Regulations provides that foreign enterprises must register with the local tax authorities thirty days after the commencement of operations or thirty days prior to closing down an operation.⁸⁹ The foreign enterprises are also required to file their in-

86. Provisional Regulations on Interest Earned, *supra* note 9, art. 2.

87. Provisional Regulations for the Establishment of Representative Offices in China by Overseas Chinese and Foreign Financial Institutions, issued by the People's Bank of China, Feb. 1, 1983; Ching, *China Softens its Tax Regulations on Income by Foreign Companies*, Asian Wall St. J., Mar. 14, 1983 at 10.

88. Provisional Regulations on Earned Interest, *supra* note 9, art. 2.

89. Foreign Enterprises Tax Regulations, *supra* note 2, art. 35. This provision has since

come tax returns and accounting statements with the local tax authorities.⁹⁰ If a foreign enterprise operates in several locations, it must register with the tax authority of each location unless it uses a consolidated accounting method for all China-related income.⁹¹ Those foreign enterprises unable to file a return within the prescribed time limit may request an extension from the local tax authorities.⁹² The income tax returns and certificates will be printed by the General Taxation Bureau of the Ministry of Finance of the People's Republic of China.⁹³ The local tax authorities also must approve sales invoices and business receipts of the foreign enterprises.⁹⁴

I. Penalties for Violations

To encourage prompt tax payments, late tax payments are subject to a fine of one-half of one percent for each day of delinquency.⁹⁵ Other specific violations of the Law may also be penalized, but the fine is limited to a maximum of 5000 *yuan*.⁹⁶ The same penalties are also set for specific violations of the Regulations.⁹⁷ The Foreign Enterprises Tax Regulations define "evasion of income tax" as "deliberate violations of the provisions of the tax laws by forging, altering or destroying ledgers, receipts or vouchers for entry account entries, misrepresenting and overstating costs and expenditures, concealing or understating the amount of taxable income or earnings, avoiding taxes, or by other illegal actions." "Refusal to pay income tax" is defined as resistance to the provisions of the tax law by refusing to file tax returns and produce certificates, receipts and vouchers for tax purposes, refusing to be investigated by tax authorities on financial affairs, accounting books and tax situations, refusing to pay taxes and fines according to the law, or other unlawful actions."⁹⁸ In all investigations of violations, tax authorities are required to present identification, serve notices of violation, and

been supplemented by "Temporary Provisions Promulgated on 15 April 1982 by the General Tax Bureau Under the PRC Ministry of Finance on Tax Registration for Foreign Enterprises that Begin Operations or Close Down," translated in *Foreign Broadcast Information Service*, DAILY REPORT, China, Apr. 23, 1982, at K6.

90. Foreign Enterprises Tax Regulations, *supra* note 2, art. 36.

91. Li Interview, *supra* note 28.

92. Foreign Enterprises Tax Regulations, *supra* note 2, art. 37.

93. *Id.* art. 48.

94. *Id.* art. 40.

95. Foreign Enterprises Tax Law, *supra* note 1, art. 14.

96. Foreign Enterprises Tax Regulations, *supra* note 2, art. 43.

97. *Id.* art. 44.

98. *Id.* art. 45.

maintain confidentiality of audit results.⁹⁹

While the monetary penalties are clearly stated, the Foreign Enterprises Tax Law reserves the right to refer cases of "gross violation" to the court system.¹⁰⁰ In light of China's frequent *in terrorem* trials and recent highly publicized punishments imposed on persons who have committed economic crimes, penalties imposed by the local people's court may be much more severe than the monetary punishments prescribed in the Regulations.¹⁰¹ Prison sentences for tax violations are provided for in China's Criminal Code.¹⁰²

J. Avoidance of Double Taxation

The recent United States Internal Revenue Service ruling on the creditability of the tax deals with the most important immediate problems of double taxation.¹⁰³ This Article will not provide an analysis of the ruling.

The United States has also invited China to negotiate a tax treaty, but it is unlikely that any such treaty will be concluded within the next two to three years.¹⁰⁴ It is interesting to note, however, that the Foreign Enterprises Tax Law and the Foreign Enterprises Tax Regulations do not provide for any mechanism to avoid double taxation in the event that a treaty does cover this subject. The Law and Regulations are in direct contrast with the Joint Venture Tax Law, which specifically states that should a treaty be concluded between China and a foreign country, the treaty provisions will govern.¹⁰⁵ To date, the only tax treaty signed between China and the United States is a limited tax treaty governing the avoidance of double taxation of air and shipping vessels.¹⁰⁶

99. *Id.* arts. 41, 46.

100. Foreign Enterprises Tax Law, *supra* note 1, art. 15.

101. Ching, *China's Crackdown On Economic Crimes*, Asian Wall St. J., March 18, 1982, at 6.

102. Criminal Code of the People's Republic of China, passed July 1, 1979, 2d Sess. of the Fifth National People's Congress, arts. 121, 123.

103. *See supra* note 46.

104. The latest discussions took place in September of 1982; *Tax Treaty Talks With China Set for September*, DAILY TAX REP. (BNA) No. 140, at 1 (July 21, 1982). Talks scheduled for May of 1983 were postponed until July of 1983. The United Nations Model Treaty is one model used as the basis of negotiations. *Talks with China on Income Tax Treaty to Resume in July*, 2 TAX TREATIES (CCH) ¶ 1403 (Apr. 29, 1983).

105. Joint Venture Tax Law, *supra* note 3, art. 16.

106. Tax treaty between the People's Republic of China and the United States Concerning Double Taxation of Aircraft and Sea Vessels, signed on February 3, 1982, effective retroactively to January 1, 1981, after ratification and approval procedures have been completed on both sides. Agreement with the People's Republic of China with Respect to Mutual

K. Comparison With Joint Venture Tax Law

For a company making a business decision on how to proceed with an investment in China, the tax consequences are an important element of that decision. The company's form of investment will subject its Chinese operations to tax under either the Foreign Enterprises Tax Law or the Joint Venture Tax Law. One law may provide significant advantages over the other law for the particular activity contemplated.

Other than the law's inclusion of provisions which relate to specific enterprises, the Joint Venture Tax Law and the Foreign Enterprises Tax Law are, on the whole, similar in language and concept. Certain major differences, however, do exist and should be considered in determining what form of investment to pursue in China.

1. Tax Rates

Perhaps the single most noteworthy difference between the two tax laws is their tax rates. The Joint Venture Tax Law provides for a maximum tax rate of thirty percent and an effective rate of thirty-three percent if the local surtax is included. The Foreign Enterprises Tax Law provides a maximum tax rate of approximately fifty percent, including the ten percent local tax, for income over one million *Renminbi*. This distinction presumably is designed to influence larger investors to structure their investments as joint ventures. At the time of the initial promulgation of the Foreign Enterprises Tax Law, a spokesperson for the Chinese Ministry of Finance indicated that the government is aware that the tax consequences for medium and smaller size foreign enterprises would be more favorable under the Foreign Enterprises Tax Law, and that this enactment was specifically designed to encourage medium and smaller size investments.¹⁰⁷

2. Reductions and Exemptions

With regard to tax reductions and exemptions, the Foreign Enterprises Tax Law provides fewer incentives than does the Joint Venture Tax Law. While the Joint Venture Tax Law allows all joint ventures to enjoy the possibility of an exemption from or reduction of tax pay-

Exemption from Taxation of Transportation Income of Shipping and Air Transport Enterprises, Mar. 5, 1982, United States-China, TREATY DOC. NO. 97-24, reported in 82 DEP'T ST. BULL. 91 (June 1982). See also Lassila, *The China Shipping and Aircraft Tax Treaty*, INT'L TAX TREATY (1982).

107. China Econ. News, Mar. 8, 1982, at 1.

ments, the Foreign Enterprises Tax Law limits exemption and reductions to enterprises engaged in specific industries or in "low profit" enterprises.¹⁰⁸

Reductions and exemptions under the Foreign Enterprises Tax Law are also subject to the discretion of the tax authorities. Chinese authorities have similar discretion under the Joint Venture Tax Law, although the Law of the People's Republic of China on Joint Ventures using Chinese and Foreign Investment provides the general rule that all joint ventures with "up to date technology by world standards may apply for a reduction of or exemption from income tax for the first two to three profit making years."¹⁰⁹ Although this statute appears to provide a limitation on the type of joint ventures allowed to apply for a tax exemption, the Joint Venture Tax Law itself allows all parties entering into ventures intended to have a life of ten years or more to apply for such reductions.¹¹⁰

The Joint Venture Tax Law provides for a refund of taxes paid if a joint venture reinvests its share of profits for a period of five years or more.¹¹¹ This benefit is not available under the Foreign Enterprises Tax Law.

3. Status: A Nontax Consideration

Another major advantage of operating as a joint venture rather than as a foreign enterprise lies in the status under Chinese law of an equity joint venture. An equity joint venture is considered a "Chinese organization" and, therefore, will be given preferences wherever laws indicate that preferences are due for Chinese companies.¹¹² This status may provide greater access to materials, services, and markets than would otherwise be available. For example, the Regulations of the People's Republic of China on the Exportation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises provide:

The operator must give preference to manufacturers and engineering companies within the territory of the People's Republic of China in concluding subcontracts for all facilities to be built in im-

108. Foreign Enterprises Tax Law, *supra* note 1, arts. 4, 5.

109. The Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, promulgated July 8, 1979, art. 7.

110. Joint Venture Tax Law, *supra* note 3, art. 5.

111. *Id.* art. 6.

112. Regulations for the Implementation of the Law of the People's Republic of China in Joint Ventures Using Chinese and Foreign Investment, promulgated Sept. 20, 1983 [hereinafter cited as the Joint Venture Regulations], art. 2.

plementing the petroleum contract, including artificial islands, platforms, building and structures, provided that they are competitive in quality, price, delivery schedule and services.¹¹³

. . . .

As for the equipment and materials required to implement the petroleum contract, the operator and subcontractors shall give preference to procuring and using equipment and materials manufactured and supplied by the People's Republic of China, provided that these are competitive.¹¹⁴

Since an equity joint venture operating in China is viewed as a Chinese legal entity, products manufactured by the joint venture would most likely be considered Chinese products. By the same analysis, joint venture manufacturing facilities and engineering companies would also be given preference to provide services.

As more Chinese laws are enacted which affect foreign investors, it is highly likely that the present stated preferences for Chinese products produced by Chinese entities and Chinese personnel will be incorporated. If so, foreign investors interested in long-term investments in China would probably do well to structure their investments as joint ventures, enjoying the lower tax rates, tax exemptions and reductions, the protection of any tax treaty entered into, and the status of being a "Chinese enterprise" with its related benefits.

Foreign companies, on the other hand, must also consider the length of negotiations on joint ventures and the greater degree of entanglement in the uncertainties and frustrations necessarily involved in dealing with the Chinese bureaucracy. There are also practical problems with having a Chinese partner. The sharing of the control of the operations, the joint decision-making processes, and potential disputes between the parties over the goals of the venture are all factors to consider in deciding which structure is preferable. In light of the foregoing considerations, foreign investors are advised to evaluate both the tax and the nontax considerations before deciding on how to do business in China.

III. CONCLUSION

Although the Foreign Enterprises Law and Regulations are important steps toward clarifying the tax liabilities of foreign businesses op-

113. Regulations of the People's Republic of China on Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises, promulgated Jan. 30, 1982, art. 19.

114. *Id.* art. 20.

erating in China, there remain many issues which must be resolved before the Law and Regulations can be properly administered. Major issues created and left unresolved by the Law and the Regulations which were raised by this article are summarized below.

A major concern for foreign businesses is the scope of the "foreign establishments" concept. The Law taxes China-source income of "foreign establishments" at a progressive rate ranging from twenty percent to forty percent and imposes a twenty percent withholding tax on the gross amount of "passive" income such as dividends, interest, and royalty payments earned by foreign companies without establishments in China. In light of the different tax consequences, it is important for the foreign investor to consider the issues raised above for complete tax planning in this area.

Of particular note is the fact that the level of activity which subjects agents or representative offices to taxation at the progressive rate has not yet been established. According to current informal interpretations by Chinese tax officials, "liaison" and promotional work will not cause representation by a company employee or an agent to be regarded as an "establishment" as long as the local representative lacks authority to sign contracts in China.¹¹⁵ It *may* be possible, therefore, to have an agent or representative negotiate contracts in China on behalf of a principal or employer without creating liability for an "establishment" if the contract does not take effect until approved by the principal or the head office. With careful planning, the foreign investor can either increase or decrease the agent's authority to create or not create an "establishment."

Another area of concern is how certain forms of transactions will be taxed. The concept of China-source income is yet undefined, and it may be possible to avoid taxation by structuring transactions so that they take place offshore. It is currently undisputed that sales of import products pursuant to contracts negotiated by a non-resident representative are not likely to be taxable under either the progressive or the alternative flat withholding rate. China-source income from compensation trade agreements whereby the foreign investor sells equipment or know-how in exchange for products manufactured from the equipment or foreign know-how may be tax exempt. Any interest earned on the sale also may be exempt from taxation. At least for compensation trade agreements signed between 1983 and 1985, interest earned will not be taxable pursuant to the Provisional Regulations on

115. Price Waterhouse Seminars, *supra* note 13.

Interest Earned.¹¹⁶

Since the Chinese taxing authorities have not yet promulgated rules regulating taxpayers with establishments who separately receive passive income, such income should be taxed at the withholding rate. Preliminary indications are that the establishment's business income and its separately received passive income will be taxed separately. The two types of income will not be taxed together under a "force of attraction" principle,¹¹⁷ unless a taxpayer has an "establishment" in China which performs services and generates income specifically connected with an agreement whereby the income would otherwise be taxable at the withholding rate.

Some definitional issues remain. The meaning of several items listed in the Regulations as non-deductible items is gradually being clarified. These items include interest on capital, certain other interest expenses, certain entertainment expenses, and royalties paid to a head office or to affiliate companies. Planning and detailed documentation may be able to increase deduction for administrative expenses paid by a foreign enterprise to its head office. Problems also exist with respect to loans which are made by foreign banks and on which interest is exempt from the withholding tax only if the loan was given at a "preferential interest rate." The term "preferential interest rate," however, as interpreted by the Chinese authorities may not be economically feasible for foreign banks. Although the Provisional Regulations on Interest Earned have made lending to China more attractive, it is still uncertain how banks will respond to the prospect of paying withholding tax after 1985. Definitional gaps also exist in provisions providing for penalties and violations under the Law and Regulations. It is still unclear whether intent and negligence are consequential elements in determining applicable penalties.

While the regulations have established some tax administration procedures, with representation and filing requirements for all foreign taxpayers subject to the tax, the implementation may take time, and adjustments may be necessary.

For tax planning purposes the regulations offer some opportunities through the depreciation and amortization schedules. The foreign investor can reduce its tax burden significantly by either creating a high

116. Provisional Regulations on Interest Earned, *supra* note 9.

117. Force of attraction refers to the principle of taxation whereby unrelated passive income is taxed at the progressive rate (usually a higher rate of taxation) rather than at the withholding rate, because the presence of the taxpayer's establishment and the existence of income subject to tax at the progressive rate.

basis for depreciable assets or leasing nondepreciable assets and deducting the leasing costs.

It is now apparently impossible to shift the burden of taxation by a contract clause making the Chinese party liable for payment of the taxes. An agreement whereby the Chinese party reimburses the foreign taxpayer for taxes paid in China is unworkable since no approval can be obtained from the Chinese authorities for such an agreement and it is, in turn, not enforceable in China.

Taxpayers subject to the Foreign Enterprises Tax Law should discuss all of these issues carefully with their Chinese partners and suggest applicable rules where the Law and Regulations are unclear or silent. In the past, contract terms stipulating tax rates or exemptions from tax prior to the enactment of laws have been honored by the Chinese government. Where there are gaps in the Law and Regulations, carefully drafted contracts provide the needed protection for the taxpayer. In more complicated matters, a written ruling from the tax bureau may be desirable.¹¹⁸

Before entering into any transaction, it is also prudent for a taxpayer to consider the differences which exist between the Foreign Enterprise Tax Law and Regulations and the Joint Venture Tax Law and determine which method is most suitable. The difference in tax rate and opportunities for tax reductions and exemptions are considerations for choosing the joint venture form. The flexibility of operating as a foreign enterprise, however, also offers a certain attraction. In any event, careful tax planning and detailed contract provisions can assist the foreign party and make investing in China a profitable venture.

118. The Tax Bureau in Beijing has indicated to a number of American attorneys its willingness to give written rulings for specific cases on application. No formal ruling procedure, however, has been established and the cost of obtaining such a ruling may be high.

